

Message Text

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ACTION EUR-08

INFO OCT-01 SS-14 ISO-00 NSC-05 INR-05 CIAE-00 EB-04
OMB-01 TRSE-00 PA-01 IGA-01 DODE-00 /040 W
-----094914 181525Z /43
R 171934Z FEB 78
FM AMEMBASSY LISBON
TO SECSTATE WASHDC 4794

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 1274

DEPT PASS TREASURY FOR SYVRUD

LIMDIS

E.O. 11652: XGDS-3
TAGS: ECON, EFIN, PO, EAID
SUBJECT: NEW MINISTER OF FINANCE AND PLANNING FACES
ECONOMIC REALITIES

BEGIN SUMMARY. DURING PRIVATE CONVERSATION FEB 16, MINISTER OF FINANCE CONSTANCIO REAFFIRMED TO ECON COUNSELOR THAT GOP EARNESTLY DESIRES PROMPT AGREEMENT WITH IMF. GOP, PARTICULARLY GIVEN THE TIME THAT HAS BEEN LOST, DOES NOT BELIEVE IT CAN MEET TARGET DEFICIT OF \$550 MILLION DURING CALENDAR YEAR 78. IT WILL ASK THE FUND TO CHANGE THE TIME FRAME FROM CY 78 TO MARCH 78-MARCH 79. DESPITE PORTUGUESE DESIRE FOR AN AGREEMENT, BASIC DIFFERENCES STILL EXIST OVER KEY ISSUES. NEGOTIATIONS WILL, THEREFORE, BE RATHER DIFFICULT, ESPECIALLY SINCE GOP BECOMING INCREASINGLY CONCERNED WITH POSSIBILITY OF SPARKING A GALLOPING INFLATION RATE. END SUMMARY

1. ECON COUNSELOR MET WITH MINISTER OF FINANCE AND PLANNING VITOR CONSTANCIO ON FEBRUARY 16. FOLLOWING SUMMARIZES MAJOR POINTS DISCUSSED.

2. IMF NEGOTIATIONS. PORTUGUESE TECHNICAL DELEGATION
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WHICH RETURNED RECENTLY FROM WASHINGTON REPORTED THAT IMF WOULD REINITIATE NEGOTIATIONS WITH GOP ONLY IF LATTER MAINTAINS PREVIOUSLY DISCUSSED TARGETS FOR EXTERNAL DEFICIT. IN EFFECT, FUND INSISTS THAT GOP ACCEPT, BY FEB 17, TARGETS OF \$800 MILLION CURRENT ACCOUNT DEFICIT AND \$550 MILLION OVERALL DEFICIT. GOP MEANWHILE HAS GROWN INCREASINGLY SKEPTICAL ABOUT ITS ABILITY TO ACHIEVE

THESE TARGETS IN CY 1978 SINCE IT HAS NOT YET IMPLEMENTED NECESSARY REFORM MEASURES. BANK OF PORTUGAL GOVERNOR SILVA LOPES PHONED FUND AND PROPOSED THAT TARGETS BE MAINTAINED, BUT THAT PERTINENT 12-MONTH PERIOD BE CHANGED FROM CY 78 TO MARCH 78 - MARCH 79. FUND OFFICIAL REPLIED BY SAYING THAT THIS PROPOSAL MUST BE PART OF FORTHCOMING NEGOTIATIONS.

3. FINANCE MINISTER CONSTANCIO NOW PLANS TO INVITE FUND EUROPEAN DIRECTOR L.A. WHITTCOME TO PORTUGAL FOR INFORMAL MEETINGS. HE HOPES TO CONVINCE WHITTOME TO WHIFT THE TARGETS' TIME FRAME AS SUGGESTED BY SILVA LOPES. CONSTANCIO FEELS CONSTRAINED BY FACT THAT HE IS COMMITTED TO SUBMITTING A 1978 DEVELOPMENT PLAN, INCLUDING CY 78 BALANCE OF PAYMENTS PROJECTIONS, TO THE NATIONAL ASSEMBLY BY MARCH 15. CONSTANCIO BELIEVES CY 78 PROJECTION, TO BE REALISTIC, MUST SHOW DEFICITS EXCEEDING THE ANTICIPATED TARGETS. HE DOES NOT WANT TO SUBMIT SUCH A HIGHER PROJECTION WITHOUT PRIOR IMF CONCURRENCE.

4. 1977 DEFICIT. THE GOP'S MOST RECENT BALANCE OF PAYMENTS ESTIMATES HAVE GENUINELY DISTURBED CONSTANCIO. THESE ESTIMATES PLACE THE 1977 MERCHANDISE DEFICIT AT SOME \$2.5 BILLION, THE CURRENT ACCOUNT DEFICIT AT \$1.25 BILLION, AND THE OVERALL DEFICIT (EXCLUDING COMPENSATORY FINANCING) AT \$1.4 BILLION. THESE SURPRISINGLY HIGH DEFICITS AUGMENT

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GOP FEARS THAT IT CANNOT ACHIEVE THE PREVIOUSLY DISCUSSED TARGETS. IN ADDITION, CONSTANCIO REMAINS SKEPTICAL THAT THE PRINCIPAL PROPOSED CORRECTIVE MECHANISMS, I.E., INTEREST RATES, DEVALUATION AND CREDIT CEILINGS, WILL PRODUCE THE PREDICTED RESULTS.

5. INFLATION. CONSTANCIO IS PARTICULARLY CONCERNED THAT THE RECOMMENDED ECONOMIC PROGRAM MAY SPARK A SHARP RISE IN THE CONSUMER PRICE INDEX. HIS INITIAL STUDIES INDICATE THAT, IN ORDER TO EQUATE MARKET PRICES TO REAL ECONOMIC COSTS, ELECTRICITY TARIFFS MUST RISE 35-50 PERCENT, MAIL RATES BY 20 PERCENT, DOMESTIC GAS BY 50 PERCENT, WATER BY 30 PERCENT AND TRANSPORT SERVICES BY 30 PERCENT. HIS REVIEW OF BASIC FOOD PRICES IS NOT COMPLETE, BUT PRELIMINARY DATA INDICATE THAT THEY WOULD HAVE TO RISE BY 30 TO 50 PERCENT IN ORDER TO REFLECT REAL COSTS. CONSTANCIO NOW FEARS, MOREOVER, THAT MANY OTHER PRICES MAY ALSO HAVE TO RISE PRECIPITOUSLY BECAUSE THEY WERE REPRESSED DURING THE LATTER HALF OF 1977. THIS FEAR OF GALLOPING INFLATION MAKES HIM INCREASINGLY RELUCTANT TO DEVALUE THE ESCUDO SUBSTANTIALLY, PARTICULARLY SINCE HE DOES NOT ANTICIPATE A LARGE, IMMEDIATE SHORT-TERM

BENEFIT FROM DEVALUATION.

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-----095500 181524Z /43

R 171934Z FEB 78
FM AMEMBASSY LISBON
TO SECSTATE WASHDC 4795

C O N F I D E N T I A L SECTION 2 OF 2 LISBON 1274

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6. 1978 CENTRAL GOVERNMENT BUDGET. THE FINANCE MINISTRY'S REVIEW OF THE 1978 BUDGET PROPOSAL HAS AGGRAVATED THESE FEARS. THE REVIEW INDICATES THAT REVENUE PROJECTIONS IN THE INITIAL BUDGET PRESENTATION WERE EXAGGERATED BY AS MUCH AS 9 BILLION ESCUDOS. THIS EXAGGERATION STEMS FROM TWO BASIC CAUSES. FIRST, THE BUDGET INCLUDED ANTICIPATED REVENUES THAT WERE UNREALISTIC, E.G., RENTAL PAYMENTS FROM AGRICULTURAL COOPERATIVES IN THE ALENTEJO. SECOND, THE PROPOSED TAX INCREASES WILL PROBABLY BECOME EFFECTIVE IN MAY, RATHER THAN IN JANUARY AS THE BUDGET SUBMISSION HAD ANTICIPATED. CONSTANCIO HAS REQUESTED ALL MINISTRIES TO REDUCE THEIR PROPOSED 1978 EXPENDITURES BY 5 PERCENT, WHICH WOULD GENERATE A SAVINGS OF ABOUT 11 BILLION ESCUDOS. HE IS NOT, HOWEVER, TERRIBLY OPTIMISTIC THAT THIS REQUEST WILL PROVE FEASIBLE.

7. WAGE POLICY. CONSTANCIO INSISTS ON HOLDING THE MAXIMUM 1978 WAGE INCREASE TO 20 PERCENT IN ORDER TO SAFEGUARD THE GOVERNMENT'S ECONOMIC PROGRAM. A GALLOPING INFLATION RATE, HOWEVER, WOULD MAKE THE 20 PERCENT CEILING UNTENABLE. THE UNIONS CURRENTLY SEEM WILLING TO ACCEPT A 20 PERCENT CEILING, BUT THEIR ATTITUDE WOULD UNDOUBTEDLY

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CHANGE DRASTICALLY IF PRICES RISE MUCH FASTER THAN AT PRESENT. IF THEY CHANGE THEIR ATTITUDE, THE UNIONS COULD WREAK HAVOC WITH THE GOVERNMENT'S ECONOMIC PROGRAM BY CALLING REPEATED BRIEF BUT HIGHLY DISRUPTIVE, STRIKES.

8. RESERVES. CONSTANCIO STATED THAT BALANCE OF PAYMENTS RESULTS FOR JANUARY WERE EXTREMELY BAD, BUT DID NOT PROVIDE SPECIFIC FIGURES. AT PRESENT, BANK OF PORTUGAL LIQUID RESERVES ARE SLIGHTLY LESS THAN \$300 MILLION. ALTHOUGH IT IS SELLING APPROXIMATELY \$50 MILLION IN GOLD, ITS LIQUID RESERVES WILL FALL TO ABOUT \$250 MILLION BY THE END OF FEBRUARY. CONSTANCIO ACKNOWLEDGED THAT THESE GOLD SALES, THOUGH HELPFUL OVER THE SHORT-TERM, OFFER NO REAL SOLUTION. IN FACT, HE IS CONVINCED THAT PORTUGAL MUST MAINTAIN A REASONABLE STOCK OF UNCOMMITTED GOLD IN ORDER TO PROTECT ITS SHORT-TERM CREDIT POSITION.

9. COMMENT: CONSTANCIO CLEARLY HAS TAKEN CHARGE AND IS THE GOVERNMENT'S UNDISPUTED ECONOMIC POLICY MAKER. HE COMPLETELY ACCEPTS THE NEED FOR A BASIC SOLUTION TO THE EXTERNAL IMBALANCE AND WILL, THEREFORE, SEEK A PROMPT AGREEMENT WITH THE IMF. NEGOTIATIONS WILL NOT, HOWEVER, BE EASY. CONSTANCIO IS NOT YET CONVINCED THAT A MAJOR INTEREST RATE INCREASE AND A DEVALUATION WILL HAVE THE DESIRED RAPID EFFECT, BUT GENUINELY FEARS THEIR POSSIBLE PRICE IMPACT. HIS CONCERNS, ONE MUST NOTE, ARE BASED ON STRICTLY ECONOMIC CONSIDERATIONS. EMBASSY BELIEVES HE WOULD BE WILLING TO ADJUST HIS BELIEFS, BUT ONLY IF THE IMF PRESENTS A GENUINELY PERSUASIVE CASE.

10. IN RESPONSE TO REQUESTS FROM BANK OF PORTUGAL GOVERNOR SILVA LOPES, ON INSTRUCTIONS OF THE FINANCE MINISTER, CONFIDENTIAL

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EMBASSY WILL REINITIATE FORMAL NEGOTIATIONS OF OUR \$300 MILLION LOAN ON TUESDAY, FEBRUARY 21.
FERRER

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Message Attributes

Automatic Decaptioning: Z
Capture Date: 01 jan 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: FINANCE, CABINET, PERSONNEL APPOINTMENTS
Control Number: n/a
Copy: SINGLE
Draft Date: 17 feb 1978
Decaption Date: 20 Mar 2014
Decaption Note: 25 YEAR REVIEW
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 20 Mar 2014
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1978LISBON01274
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: X3
Errors: N/A
Expiration:
Film Number: D780076-0192
Format: TEL
From: LISBON
Handling Restrictions:
Image Path:
ISecure: 1
Legacy Key: link1978/newtext/t19780242/aaaabjtm.tel
Line Count: 214
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: 40f7a2d4-c288-dd11-92da-001cc4696bcc
Office: ACTION EUR
Original Classification: CONFIDENTIAL
Original Handling Restrictions: LIMDIS
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 4
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: LIMDIS
Reference: n/a
Retention: 0
Review Action: RELEASED, APPROVED
Review Content Flags:
Review Date: 01 jun 2005
Review Event:
Review Exemptions: n/a
Review Media Identifier:
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
SAS ID: 3563483
Secure: OPEN
Status: NATIVE
Subject: NEW MINISTER OF FINANCE AND PLANNING FACES ECONOMIC REALITIES BEGIN SUMMARY. DURING PRIVATE CONVERSATION
FEB 16
TAGS: ECON, EFIN, EAID, PO
To: STATE
Type: TE
vdkgvwkey: odbc://SAS/SAS.dbo.SAS_Docs/40f7a2d4-c288-dd11-92da-001cc4696bcc
Review Markings:
Sheryl P. Walter
Declassified/Released
US Department of State
EO Systematic Review
20 Mar 2014
Markings: Sheryl P. Walter Declassified/Released US Department of State EO Systematic Review 20 Mar 2014